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No. 280

In the Supreme Court of the United States

OCTOBER TERM, 1936

SAMUEL A. SALVAGE, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 49–56) is unreported. The opinion of the Circuit Court of Appeals (R. 135–140) is reported in 76 F. (2d) 112.

JURISDICTION

The judgment of the Circuit Court of Appeals, reversing the decision of the Board of Tax Appeals in part and affirming it in part, was entered on March 25, 1935. (R. 140.) An order granting an

extension of time thirty days from June 25, 1935, for filing a petition for certiorari was issued June 25, 1935. The petition for a writ of certiorari was filed July 25, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Circuit Court of Appeals erred in holding that stock of the Viscose Company, subject to a gradually expiring option to repurchase at par, had a fair market value not in excess of its par value as of the date of acquisition by the taxpayer.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and other authorities involved are set forth in the Appendix, *infra,* pp. 12–18.

STATEMENT

The following facts are taken from the stipulation of facts, the memorandum opinion of the Board of Tax Appeals and the deposition of the taxpayer.

In 1929 the taxpayer received $671,000 from the redemption of 6,100 shares of preferred stock of the American Viscose Corporation. (R. 49, 51.) This stock had been acquired December 30, 1922, together with 7,625 shares of common stock, in exchange for stock of the Viscose Company, under the following circumstances:

In December, 1922, the taxpayer, an officer and employee of the Viscose Company, held 25 shares

of common stock of that company, which he had purchased at $166.66-2/3 a share. (R. 49.) At that time the Viscose Company increased its capital stock by 4,000 shares and permitted him to purchase 1,500 shares at $100 a share. (R. 83–91.)

This purchase was made pursuant to a contract of December 30, 1922, between the taxpayer and the Viscose Company. The contract in question provided that the corporation should sell 1,500 shares of stock to the taxpayer at par. In consideration the taxpayer agreed not to engage in any competing business and that the corporation should have the right to repurchase five-sevenths of the shares at par at any time during 1923, four-sevenths during 1924, three-sevenths during 1925, two-sevenths during 1926 and one-seventh during 1927. (R. 28–30.)

On the same date that this agreement was made with the Viscose Company (hereinafter called the old company), the American Viscose Corporation (hereinafter called the new company) was incorporated in Delaware and issued 4 shares of its preferred and 5 shares of its common stock in exchange for each share of common stock of the old company. (R. 24–25.) On that date the taxpayer exchanged his 1,525 shares, which had cost him an aggregate sum of $154,166.66, for 6,100 shares of new preferred and 7,625 shares of new common, pursuant to an agreement whereby the option attaching to the old shares was transferred to the

new. (R. 51, 103, 104.) The option was never exercised. (R. 51.)

In his 1929 return, the taxpayer reported as a gain from the redemption of the preferred stock, the difference between $671,000, the amount received, and $154,166.66, the entire cost of all the shares of the old company. (R. 51.)

The Commissioner determined a deficiency of $12,005.38 by ruling that 37.778 percent of the cost basis of the old stock should be apportioned to the new preferred stock and 62.222 percent of such basis to the new common stock. This apportionment was made according to the relative market values of the new preferred and new common stock at the time of the exchange. (R. 26, 27, 39, 49, 51–52.) This apportionment gave a basis of $58,123.47 for the preferred stock and was used by the Commissioner in measuring the gain. (R. 26.)

Before the Board the taxpayer contended that it was not practicable to determine the market value of the preferred and common stock as of December 30, 1922, that no apportionment of the cost basis of the old stock between the new preferred and new common stock should be made, and that the entire cost should be used as a basis. In addition, he claimed a refund of $63,750, based on the contention that the proper basis of the stock received in exchange for the 1,500 old shares was not the cost of such 1,500 shares ($100 per share), but their fair market value as of the time of their acquisition ($1,164.70 per share), on the theory that the dif-

ference represented compensation for services. (R. 4–5, 19, 52–53.)

The Board determined that the difference was not compensation for services and that neither the taxpayer nor the old company had so treated it for tax purposes. (R. 54–55.) It held that the basis was the cost of the old stock and that the basis was properly apportioned by the Commissioner. (R. 55–56.)

The court below, while agreeing that the difference between the cost and market value of the old stock was not compensation for services in 1922, held that it was income realized at that time from a promise not to engage in a competing business and that the taxpayer was not estopped to present this claim. It, therefore, held that the basis of the 1,500 shares was market value and not cost, but that only two-sevenths of those shares had a market value of $1,164.70 and the remaining five-sevenths a market value of $100 a share, because of the option for repurchase by the corporation, so that the aggregate market value was $606,300.

The court further held that the basis of the old shares ($4,166.66 for the 25 shares and $606,300 for the 1,500 shares) should be apportioned according to the method used by the Commissioner, which would apportion $230,662.09 to the preferred stock. Since this was in excess of the basis originally reported by the taxpayer, the court held that there was no deficiency and directed the Board to determine the amount of refund due.

ARGUMENT

While we believe that the question presented by this petition was correctly decided below and does not of itself merit review, we do not oppose the granting of the writ if a writ is granted upon the petition of the Commissioner in the same case, No. 173, present term. The questions presented in the two petitions involve the proper basis for computing gain on the same shares of stock, and it may be desirable that the Court have an opportunity to pass upon the question in its entirety.

If a writ is not granted in No. 173, we do oppose the granting of this petition.

The only issue raised by the taxpayer is whether the court below erred in reversing the Board's determination that all the common stock received by the taxpayer from his employer, the Viscose Company, on December 30, 1922, had a fair market value of $1,164.70 a share, and in holding that, with respect to the five-sevenths of the stock subject to an option to repurchase, the market value was $100 a share, the stated repurchase price.

There is no question but that the stock of the Viscose Company in general, as distinguished from that acquired by the taxpayer, had a fair market value of $1,164.70 a share. The Board so found and the court below did not disturb that finding but held that five-sevenths of the particular stock purchased by the taxpayer did not have such a value because of the option to repurchase. The fair

market value of those shares as distinguished from that of the stock in general is material solely because of the decision of the court below that the fair market value of the stock of the old company, rather than cost, constituted the basis for measuring the gain or loss from any subsequent disposition of the stock of the new company received in exchange for it, upon the theory that the difference constituted income received in 1922 in consideration of an agreement not to compete. (See T. D. 3435, II–2 Cumulative Bulletin 50, *infra*.) The fair market value of the old shares will not be material if this Court should sustain the Government's position in No. 173 that the taxpayer is estopped to deny that the basis is cost by virtue of his failure to report the difference between the cost and fair market value of the old stock as income in 1922.[1]

The taxpayer argues that the option agreement should not be taken into account in determining the

[1] Whichever basis is used, an apportionment of that basis between the new common and new preferred stock is required to ascertain the portion attributable to the preferred stock, and thus measure the gain realized from the redemption of the preferred stock in 1929. The court below apportioned the basis according to the respective market values of the two classes of stock at the time of the exchange without regard to restrictions on the taxpayer's particular stock. Since the new preferred as well as the new common stock was subject to this option, we believe that this procedure was correct and the taxpayer does not challenge it. The percentages assigned to the two classes are therefore the same as in the Commissioner's determination.

fair market value of five-sevenths of his stock and that if it should be, the Court should also have considered the fact that the option was released as to one-fifth of the five-sevenths each year and that it should have remanded the case to the Board to find the values of the stock as it was released from the option.

The taxpayer cites no authorities in support of his suggestion that stock subject to an option to repurchase at a price substantially below its market value has the same market value as stock not subject to option, and we know of none. *Wilson* v. *Bowers,* 57 F. (2d) 682 (C. C. A. 2d), and *Markle* v. *Commissioner,* 10 B. T. A. 763, 794, support the view of the court below that it does not have the same value.[2]

---

[2] This situation is to be distinguished from one in which the taxpayer voluntarily agrees not to sell his stock for a certain period. In such cases he has received an asset of a fair market value, equal to that of unrestricted stock, even though he has agreed to retain it for a period. *Helvering* v. *Kendrick Coal & Dock Co.*, 72 F. (2d) 330 (C. C. A. 8th), certiorari denied, February 18, 1935; *Newman* v. *Commissioner*, 40 F. (2d) 225 (C. C. A. 10th), certiorari denied, 282 U. S. 858; *Fesler* v. *Commissioner*, 38 F. (2d) 155 (C. C. A. 7th); *Rodrigues* v. *Edwards*, 40 F. (2d) 408 (C. C. A. 2d); *G & K Mfg. Co.* v. *Commissioner*, 76 F. (2d) 454 (C. C. A. 4th), now pending before this Court on petition for a writ of certiorari, No. 187, October Term, 1935, the granting of which has been opposed by the Government insofar as that issue is concerned.

We believe that the decision of the court below was clearly right on this issue and that in so holding it was not making a finding of fact as suggested by the taxpayer, but was ruling that the Board's finding that the stock had a fair market value of $1,164.70 was not supported by any substantial evidence in so far as the stock subject to the option was concerned, the evidence conclusively establishing that it had a fair market value equal to the option price.

The value of the stock as it was released from the option is not material. The old stock was never released from the option, but was exchanged for the new, and if market value is the basis for gain upon sale, as the taxpayer insists and the court below held, it is the market value of the old and not of the new which constitutes that basis. There is no question that the exchange of old shares for new was a non-taxable transaction. If market value is the proper basis, it is so upon the court's theory that the difference between the cost of the old stock and its fair market value when received in 1922 constiuted income at that time. Subsequent events changing the situation with reference to the new stock cannot be taken into account in fixing the fair market value of the old stock as of the time of its receipt in 1922.

But even if it had been the old stock which was released from the option, the same rule would

apply. It would be manifestly unreal to ascribe to stock a market value in excess of par in 1922 when at that time the stock was subject to an option to repurchase at that price. The fact that the option was not exercised and expired in subsequent years is immaterial. In determining the fair market value of property as of a given date, only such future events as could reasonably have been anticipated may be taken into account. *Ithaca Trust Co.* v. *United States,* 279 U. S. 151; *Johnson* v. *United States,* 44 F. (2d) 244 (C. Cls.); *Robertson* v. *Routzahn,* 75 F. (2d) 537 (C. C. A. 6th); *William H. Jackson Co.* v. *Commissioner,* 2 B. T. A. 411; *Keller Mechanical Engineering Corp.* v. *Commissioner,* 6 B. T. A. 990. Compare, *contra, H. H. Miller Industries Co.* v. *Commissioner,* 61 F. (2d) 412, 414 (C. C. A. 6th). See also *Virginia* v. *West Virginia,* 238 U. S. 202, 227.

Finally, the taxpayer suggests that the Court could not decide this issue, for the reason that the question was not raised in the court below. But the correct basis for the stock was in issue, all of the facts were before the court, and it had authority to notice a plain error, though not assigned, if it chose to do so. For further reply to that contention, we respectfully refer to our brief in opposition in the case of *General Utilities & Operating Co.* v. *Helvering,* No. 41, October Term, 1935.

CONCLUSION

The taxpayer's petition presents no question of general importance and none in which there is any conflict of decisions. Hence the petition should be denied unless the petition in No. 173 is granted.

Respectfully submitted.

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SEPTEMBER, 1935.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a

recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(6) *Tax-free exchanges generally.*—If the property was acquired upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it;

* * * * *

Revenue Act of 1921, c. 136, 42 Stat. 227, 237:

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *

Treasury Regulations 62, promulgated under the Revenue Act of 1921:

ART. 1567. *Gain or loss from subsequent sale.*—(a) Where property is exchanged for other property and no gain or loss is recognized under articles 1564 or 1566 the property received shall for the purpose of determining gain or loss from its subsequent sale

be treated as taking the place of the property exchanged therefor. But see article 1568. For exchange of property acquired prior to March 1, 1913, see article 1561. If property is exchanged for two kinds of property and no gain or loss is recognized under articles 1564 or 1566 the cost of the original property should be apportioned, if possible, between the two kinds of property received in exchange for the purpose of determining gain or loss upon subsequent sale. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the property received in exchange is realized until out of the proceeds of sale shall have been recovered the entire cost of the original property. When securities of a single class are exchanged for new securities of different classes so that no gain or loss is realized under the provisions of paragraph (b) of article 1566, for the purpose of determining gain or loss on the subsequent sale of any of the new securities the proportion of the original cost, or other basis, to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. For example, if 100 shares of common stock, par value $100, are exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the old stock was $250 per share, or $25,000, but the market value of the preferred on the date of the exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the

preferred and four-fifths, or $20,000 as the cost of common. The same method of computation should be used in the case of stock acquired prior to March 1, 1913, in order to ascertain the proportion of such value to be allocated to each class of new securities on that date and the taxable gain or deductible loss should thereafter be computed in accordance with article 1561.

(b) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in sections 214 (a) (12) and 234 (a) (14) and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall for the purpose of determining gain or loss from its subsequent sale be treated as taking the place of a like proportion of the property converted. See articles 261–263.

(c) Where no deduction is allowed by sections 214 (a) (5) and 234 (a) (4) for total or partial loss on sale or exchange of securities, that part of the securities acquired with relation to which such loss is disallowed shall for the purpose of computing gain or loss from a subsequent sale be treated as taking the place of the securities sold or disposed of. See article 147.

T. D. 3435, II–2 Cumulative Bulletin 50:

Where property is sold by a corporation to a shareholder or member, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder or member of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its

fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition.

I. T. 2335, VI–1 Cumulative Bulletin 18:

REVENUE ACT OF 1926

"Where in a reorganization a stockholder receives in exchange for common stock in a corporation a party to a reorganization similar stock and other classes of stock in another corporation a party to the reorganization, he should allocate the cost of the common stock surrendered between the different classes of stock received in exchange in the proportion of the fair market values of such different classes of stock at the date of the exchange."

Request is made for information as to the proper basis to be assigned to each class of securities received by A in certain transactions. The transactions fall within the class of exchanges of stock and securities for other stock and securities in a reorganization in which no gain or loss is recognized under section 203 (b) 2 of the Revenue Act of 1926.

It is to be noted that there is no provision in Regulations 69 interpreting the Revenue Act of 1926 which corresponds to article 1567 of Regulations 62 interpreting the Revenue Act of 1921, which reads in part:

"* * * the proportion of the original cost, or other basis, to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. * * *"

In the opinion of this office the provision of article 1567 of Regulations 62, quoted

above, lays down a principle which is equally applicable to reorganizations under the Revenue Act of 1926. (See article 1599, Regulations 69.)

In the event of the subsequent sale of stock received in a reorganization and the reporting of gain or less therefrom, the taxpayer should file with his return a statement showing the basis (computed in accordance with the principle referred to) used for the determination of the gain or loss, together with any evidence he may have to support such basis.

U. S. GOVERNMENT PRINTING OFFICE: 1938